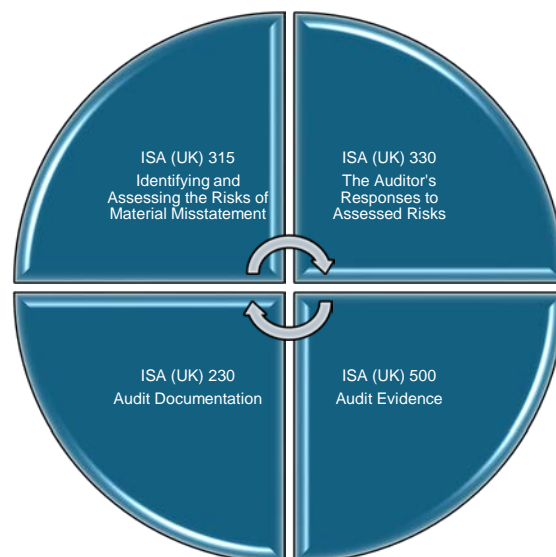


Assessing risk in line with other ISAs (UK) (Lecture A 888 – 15.04 minutes)

All audits are carried out on a risk basis and risk is a critical aspect of audit planning. Audit planning is carried out in accordance with the ISAs (UK) in the 300 series and ISA (UK) 315 *Identifying and Assessing the Risks of Material Misstatement* is the ISA (UK) that focuses specifically on identifying risks. ISA (UK) 330 *The Auditor's Responses to Assessed Risks* then requires the auditor to obtain sufficient appropriate audit evidence concerning the assessed risks of material misstatement by designing and implement appropriate responses to those risks.

Reviews of audit files has indicated that firms are getting better at risk assessment, though there are some deficiencies identified when looking at how firms have implemented the latest edition of ISA (UK) 315. In addition, there is often overlap with the ISAs (UK) and in this respect we will look at how risk interacts with the other ISAs (UK) as follows:



ISA (UK) 315

ISA (UK) 315 is not a light read by any stretch of the imagination and is a very detailed standard. The objective of this ISA (UK) is to require the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels to provide a basis for designing and implementing responses to the assessed risks of material misstatement.

The **financial statement level** refers to the financial statements as a whole. For example, the risk that the going concern basis of accounting has been used inappropriately. The **assertion level** refers to the individual transactions, balances and disclosures (such as the valuation assertion for trade debtors or the completeness assertion for revenue). For completeness, ISA (UK) 315 defines 'assertions' as:

Representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in

management representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.

Acquiring an understanding of the entity and the environment in which it operates is critical as it impacts the auditor's risk assessment. From the risk assessment process comes the specific audit procedures that the auditor will apply which respond to those risks. If the auditor fails to gain a sufficient understanding of the entity and the environment in which it operates, together with the client's system of internal control, they will be unable to carry out a thorough risk assessment. This increases audit risk (which is the risk that the auditor forms an incorrect opinion on the financial statements) and the whole point of audit planning is to reduce this risk to an acceptable level.

Example – Understanding the entity

Morley Industries Ltd is in the technology sector and operates from five sites. It has been established for many years, achieving high profits and paying a high level of dividends to its shareholders. Eight months ago, the company recruited a new finance director who overhauled the finance department and introduced a new bespoke accounting system as well as new financial policies and procedures.

During initial discussions with the finance director, it was brought to the auditor's attention that new entrants to the market have become a threat to the client because of their competitive pricing structures. The audit firm has acted for Morley Industries for four years and the auditor is aware that the client has a significant market share, hence the emergence of these competitors could impact on that share and could ultimately affect the client's going concern status.

The auditor must obtain an understanding of how these threats impact on the entity so that appropriate audit procedures can be devised to address these risks – for example, performing additional audit procedures over going concern.

These additional risks may have had an impact already on Morley Industries' financial performance during the year. It is important that the auditor develops a sound understanding of how these additional risks *could* impact the financial statements. For example, management may manipulate the revenue figure in the financial statements to achieve a higher profit to secure any additional financing requirements which the company may be applying for; or it may manipulate the financial statements to portray a healthier financial performance and position than it really has.

In addition, the auditor will also need to look at the entity's business operations in its entirety. The company operates from five sites and so the audit engagement team will need an understanding of how each site operates and the controls that are present at each site. This is important in light of the new financial controls that the finance director has implemented when overhauling the financial policies and procedures.

The new finance director has implemented a new accounting system so the auditor must perform a thorough review of this new system by reviewing and testing new and existing controls in addition to:

- carefully documenting the new system and considering general IT controls;
- devising procedures to ensure transactions and balances from the old to the new

system have been transferred correctly;

- reviewing any parallel running of the old and new accounting system to ensure the new system works correctly; and
- devising procedures to test controls over the new system to ensure their operating effectiveness.

The example above demonstrates why it is important not to simply 'carry over' planning from one year to the next because significant changes may have arisen from the prior year which could impact on the current year. In the example above, several changes have taken place which are likely to impact on the audit procedures that will be devised, notably:

- A new finance director has been recruited in the year. The finance director will need time to get used to the transactions and accounting systems of the client, hence giving rise to a risk of material misstatement.
- A new structure has been put in place within the finance department, which will invariably bring with it new policies and procedures. These new policies and procedures may be ineffective and/or contain fraud risk factors.
- A new accounting system has been introduced which the audit firm may not have experience of working with before (especially as it is a bespoke system). If the system is particularly complex, this introduces an added risk of material misstatement due to the system's complex nature.
- Additional competitors have emerged into the market which may threaten the client's ability to continue as a going concern.

Inherent risk and control risk assessments

Remember to separately consider inherent risk and control risk. 'Inherent risk' is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material (either individually or when aggregated with other misstatements) **before** considering any related controls. Inherent risk is presumed high if not assessed as less than high.

'Control risk' is the risk that a misstatement that could occur in an assertion (about a class of transaction, account balance or disclosure) and that could be material (either individually or in the aggregate with other misstatements) will not be:

- prevented; or
- detected **and** corrected, on a timely basis,

by the entity's system of controls.

Control risk is assessed if the auditor plans to test the operating effectiveness of the entity's controls. If not, the assessment of the risk of material misstatement is the same as the assessment of inherent risk.

ISA (UK) 330

Once the auditor has carried out the risk assessment, the next step is to devise responses to those risks.

At this stage in the planning process, the auditor looks at general business risks and the risks of material misstatement of the financial statements whether due to fraud or error. 'Business risks' are generally those risks external to the entity; for example, if the client operates in an industry that is in decline, this could mean there are potential going concern issues.

All businesses will face risks in their normal course of operations, so the auditor must obtain a sound understanding of the business and the environment in which it operates. Business risks can often arise because of:

- **Political factors** – due to changes in government policy, tax rates and changes in governments at home and abroad. This may affect companies that operate globally where, in some countries, the political climate may be volatile.
- **Economic factors** – due to changes in the economic situations of the country in which the client operates such as levels of inflation or interest rates. The auditor must consider the risks applicable in all the countries that the client operates.
- **Legislative factors** – changes in law or regulation may result in restrictions to operations or the prohibition of operations (e.g. due to sanctions imposed by governments or the banning of certain products which the client may manufacture). Changes in environmental legislation may give rise to additional costs having to be borne by the client to clean up operations.
- **Compliance factors** – risks of material misstatement may arise due to non-compliance with tax legislation or other laws and regulations. However, other legislation such as employment law may be breached by the entity, which could result in material misstatement (for example, a failure to recognise a provision for liabilities).
- **Physical factors** – natural disasters such as a fire or flood may affect the client's ability to continue as a going concern.
- **Financial factors** – credit risk, foreign exchange risk and interest rate risk are all beyond the client's control. Such factors can have a detrimental impact on the results of the entity and a previously profitable client may end up reporting current year losses.
- **Technological risk** – some clients manufacture and/or sell goods which have a relatively short shelf life due to technical obsolescence. If a business fails to spot opportunities or developments in emerging technologies, it may find itself being overtaken by competitors. This could have a detrimental impact on going concern.
- **Market risk** – factors such as increased competition, price wars and development of new products can cause a risk to a client's business.

The auditor must also consider how the financial statements themselves are at risk of material misstatement, including an assessment as to whether a material misstatement could arise because of fraud or error.

The outcome of this risk assessment will influence the audit strategy (the document that explains how the auditor will tackle the audit). This, in turn, influences the audit plan (the document that contains all the planned audit procedures, such as after-date cash receipts testing and purchase invoice sampling).

Once the auditor has identified the risks of material misstatement, responses to those risks are then required. At the planning stage of the audit, the response itself does not have to be a detailed audit procedure; rather, it is the approach that the audit engagement team will take to address the risk and the detailed audit procedures will follow during the audit fieldwork stage.

The auditor will also determine whether tests of controls could be effective in addition to substantive procedures.

The risks and response phase may involve detailed testing of internal controls, transactions and balances. When the auditor plans to rely on the client's system of internal control, tests of those controls must be carried out.

Important point

An important point to bear in mind is that tests of controls are not designed to detect material misstatements. This is because the auditor uses substantive procedures (tests of detail and substantive analytical procedures) to determine whether the financial statements give a true and fair view. In addition, tests of control do not focus on the monetary amount in the financial statements – they focus on the controls that effectively generate the financial reports.

The table below provides some examples of risks that may be identified during the planning stage of audit, together with an appropriate auditor's response:

Audit risk	Auditor's response
New entrants to the market have resulted in a small number of customers switching to a more competitively priced supplier.	Discuss with the directors how the threat by the new entrants to the market is being managed and whether the lost customers have been replaced.
There is a risk that if the business loses customers, revenue, profitability and cash flows will be affected and hence there could be a negative impact on the entity's ability to continue as a going concern.	Review the cash flow forecast, budgets and current order levels to ascertain if there is a threat to the entity's ability to continue as a going concern.
A new bonus scheme has been introduced in the year to boost sales and profitability.	Detailed cut-off procedures to be carried out on revenue recognition to ensure that revenue is recognised in the correct
There is a risk that revenue is overstated	

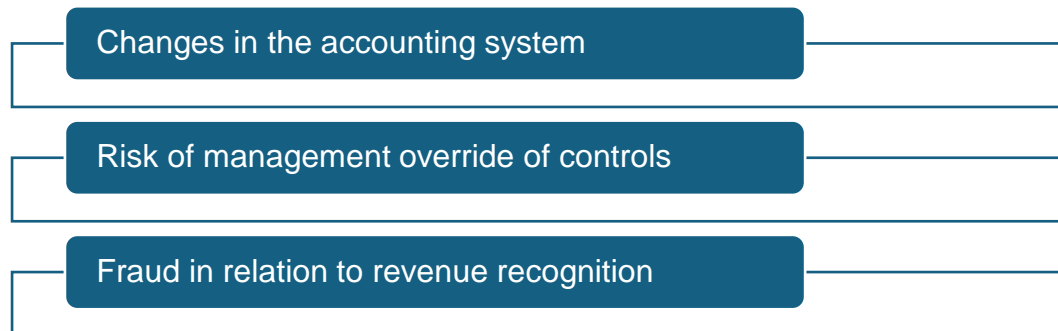
to achieve bonus targets.	accounting period, and tests to ensure that fictitious revenue is not being recorded.
The time spent on the audit in the prior year was increased by 50% due to several deficiencies in the client's system of internal control.	Discuss with management whether recommendations to improve internal controls in the prior year have been implemented and, if so, devise procedures to test those controls.
If these deficiencies have not been addressed by management, there may be a risk that misstatements will be present in the current year's financial statements.	The audit team must apply professional scepticism throughout the course of the audit and extend detailed substantive testing over high-risk areas of the financial statements.
A new accounting system has been introduced in the year which can now prepare more detailed financial reports.	Document the new accounting system in full and carry out detailed substantive procedures to assess if the closing figures in the old system have been correctly transferred to the new system.
If the opening balances from the old system have not been transferred correctly, the closing figures will not be correct hence a misstatement will be present in the financial statements.	
The company plans to apply for a listing on the London Stock Exchange (LSE) and the board of directors and shareholders are excited about this possibility.	The audit team must maintain professional scepticism, keeping in mind that there is a higher risk of material misstatement due to the company applying for a listing to the LSE.
There is a risk that the financial statements may be manipulated to show a desired level of profit and/or financial position.	

ISA (UK) 230

Documenting the planning phase is, of course, important. Audit documentation 'tells the story' of how the audit was conducted and how the audit engagement partner ultimately formed their opinion on the truth and fairness of the financial statements.

Many of the ISAs (UK) now include 'stand back' provisions and ISA (UK) 315 is one of those standards. The idea of the stand back provision is to provide the auditor with an opportunity to assess whether they have picked up all the relevant information. Hence, where ISA (UK) 315 is concerned, it would be an opportunity for the auditor to review the risks they have identified to check if there are any other significant risks that may have been omitted; or whether identified risks are complete in terms of the impact they may have on the financial statements.

Some risks will clearly be more important than others – particularly significant risks. ‘Significant risks’ include:



An important point to keep in mind is that the auditor must **always** carry out procedures over significant risks.

Documenting risks concisely and completely will also aid the review process. Often audit firms document the risk assessment in the planning section, which is fine.

However, during file reviews it is not uncommon to see the list of significant risks communicated to management and those charged with governance not reconciling with the planning documentation.

The risk assessment must be consistent throughout the audit file and needs to be thoroughly documented.

It is also not uncommon to see missing or incomplete documentation on significant risks.

Example – Construction contract revenue

The principal activity of Chambers Ltd is that of the construction of commercial buildings. The audit of the financial statements for the year ended 31 October 2024 is being planned and is currently at the risk assessment stage.

This is not a new client for the audit firm and there have been no significant changes in the business of Chambers Ltd since the previous year.

A significant risk of material misstatement has been identified in respect of revenue recognition. The company has a number of construction contracts in progress at the year end, all of which are at different stages of completion.

There should be clear documentation of this risk in the planning section of the file, together with the auditor’s responses to those risks, such as:

- Ascertaining whether controls over construction contract revenue recognition have operated effectively during the year.
- Identifying that revenue has a presumptive fraud risk, hence, is a significant risk by default.
- Considering how management identify the stage of completion at the year end and whether this method has been effective in previous audits, or whether exceptions were noted (if exceptions were noted, a more substantive approach should be adopted).

- If an external surveyor is used to assess the stage of completion, whether this surveyor is independent, has the technical competence and capabilities and has experience in valuing such work in progress. The provisions in ISA (UK) 620 *Using the Work of an Auditor's Expert* will be applicable to assess the external surveyor's work.

It is always advisable to have a separate working paper on file that document the significant risks and the auditor's approach to dealing with such risks.

ISA (UK) 500

Once all risks have been identified, auditor's responses to risks documented and the audit strategy and audit plan developed, the next step is to obtain sufficient appropriate audit evidence to **reduce audit risk**.

As noted earlier, audit risk is the risk that the auditor forms an incorrect opinion on the financial statements (e.g. expressing an unqualified audit opinion when a qualified opinion is more appropriate).

The 'traditional' audit risk model considers three essential components of audit risk to be:



As noted above, the auditor is required to carry out separate assessments of inherent risk and control risk. However, their combined effect is the **risk of material misstatement** (i.e. the risk that controls will not detect misstatements that arise due to inherent risk). The 'residual risk' is detection risk.

The auditor has no control over inherent or control risk. The only risk under the auditor's control is detection risk.

'Detection risk' refers to the risk that the audit procedures will not detect a misstatement that exists and that could be material (either individually or in the aggregate with other misstatements). There are two elements to detection risk:

- Sampling risk; and
- Non-sampling risk.

Sampling risk

This is the risk that the auditor's conclusion based on a sample is different from the conclusion that would be reached if the auditor had tested the entire population rather than just a sample.

Non-sampling risk

This is the risk that the auditor's conclusion is inappropriate for any other reason. For example, the application of inappropriate audit procedures; or the misinterpretation of audit evidence.

Keep in mind there is an **inverse relationship** between detection risk and control risk. The auditor could conclude that the risk of material misstatement is low, which means the auditor's assessment that the financial statements contain a material misstatement is low. In turn, this also means that the auditor is seeking to place reliance on the entity's system of internal control. If the risk of material misstatement is low, detection risk becomes high. This is because the auditor is seeking to place more reliance on the entity's system of internal control and will therefore do less substantive testing.

Conversely, if the auditor concludes that the entity's system of internal control cannot be relied upon and hence deems the risk of material misstatement to be high, detection risk becomes low because the auditor will undertake more detailed substantive procedures.

The level of audit evidence needed to address identified risks will be entity-specific and there is no definitive answer to this. However, ISA (UK) 500 requires audit evidence to be **sufficient and appropriate**.

'Sufficiency' relate to the quantity of evidence required. 'Appropriateness' relates to the quality of that evidence (i.e. its relevance and reliability in supporting the conclusions on which the audit evidence is based).

Example – Attempting to achieve a desired outcome

During the audit of Savoy Enterprises Ltd, an audit team member discovered a potential claim for damages brought against the client by a third-party for a breach of contract. The finance director informed the audit team member that the company is actively defending the claim and the board have decided not to include a provision for liabilities. The documentation reviewed by the audit team member indicates that the company should make a provision for liabilities as the solicitors handling the claim have informed the company that it is more than likely it will be unsuccessful.

The finance director contacted the audit engagement partner and stated:

'Look, we have worked closely with your firm for a number of years and I'd rather not have to make a provision in these accounts because not only will it look bad, but it will also have an impact on our pre-tax profit which is already lower than the previous year and the CEO wants to report as high a pre-tax profit figure as possible as the bank are about to review our borrowing facilities. Can I suggest we simply include a contingent liability disclosure, as I have already done? We do pay a lot of money for our audit and it would be a shame to have to change auditors just because of this disagreement.'

In this scenario, there are a couple of 'red flags':

- There is a risk that the audit engagement partner may 'give in' to the client and instruct the team to attempt to obtain audit evidence that supports what the client has already done (i.e. that a contingent liability is appropriate, and ignoring the audit evidence that

points to a provision being more appropriate).

- If the audit engagement partner gives in to the client, audit risk is exceptionally high. If the provision is material (either in isolation or in the aggregate) or material by nature (i.e. it turns a profit into a loss), then the audit engagement partner will be forming an incorrect opinion on the financial statements if he/she expresses an unqualified opinion.
- The levels of professional scepticism will clearly be called into question. Essentially, the audit team will be ignoring audit evidence suggesting a provision for liabilities is more appropriate and, presumably, none of this will be documented on file in an attempt to make the audit evidence stack up to the disclosure of a contingent liability being more appropriate.
- The finance director's remarks to the audit engagement partner create an intimidation threat. The finance director is effectively threatening the audit engagement partner with the firm's removal if they disagree with the finance director's treatment. The finance director has already admitted that the provision will have a detrimental impact on the financial statements and this may impact the bank's lending decision.
- In addition to the intimidation threat above, the finance director's comments may mean the financial statements have been deliberately misstated in other areas to achieve the outcome desired by the board.
- If the audit engagement partner fulfils the finance director's wishes, the audit work performed will undoubtedly be challenged by a file review or a professional body carrying out audit monitoring. This can leave the audit firm exposed to potential disciplinary action.

The key message is that the auditor cannot be put into a situation where they are attempting to get audit evidence that supports what the client has done where there is a risk that an accounting treatment or disclosure is clearly incorrect. This is particularly the case in areas which require significant amount of judgement and estimate.

If the audit evidence obtained by the auditor points to an incorrect treatment in the financial statements, the auditor **must** challenge management and ensure that this challenge is adequately documented. The auditor must also 'stand their ground' and not give in to the client – even if this results in a qualified audit opinion and subsequent loss of a client.

In addition, where risks and audit evidence are concerned, the auditor must remain alert to any audit evidence which indicates the presence of a **fraud risk factor**. However, just because the auditor may conclude that the audit evidence obtained points to a fraud risk factor being present, it does not necessarily mean that a fraud has occurred; it just means there is a higher chance of fraud occurring due to the risk factor present, which will require increased professional scepticism by the audit team. Examples of fraud risk factors include:

- incentives, pressures and opportunities;
- fraudulent financial reporting;
- weak internal controls (e.g. a lack of segregation of duties);
- risk of management override of internal controls;
- toleration of petty theft;

- corruption; and
- dissatisfied employees.

Practical 'takeaways' to keep in mind

There is a lot of overlap with the ISAs (UK) and the risk assessment phase will always overlap with the documentation and evidence-gathering stages. This is because the audit procedures will ultimately be dictated by the risk assessment.

Where risks and evidence are concerned, the key aspects to bear in mind are:

